



Working Paper 36

Limitations on Interest Deductions: A Suggested Perspective for Developing Countries

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Michael C. Durst

Summary

This paper evaluates the efforts of the Organisation for Economic Co-operation and Development (OECD), in its project on base erosion and profit shifting (BEPS), to control profit shifting by members of multinational groups through payments of interest on related-party loans. Currently, members of groups appear to be shifting large amounts of income from countries around the world to affiliates in zero- or low-tax countries, through the relatively simple expedient of creating loans between identically-owned group members. The resulting revenue losses are especially serious for developing countries, which depend more heavily than other countries on revenue from corporate income taxation; in addition, it appears that groups investing in developing countries sometimes employ tax planning through related-party loans very aggressively.

The paper evaluates the OECD's proposal for a 'group-wide' limitation on interest deductions, under which only loans obtained by group members from unrelated parties would generate deductible interest payments, and the resulting deductions would be apportioned among group members based on measures of their relative levels of economic activity. The paper agrees with the OECD's conclusion that the group-wide approach should be more difficult to avoid than existing kinds of interest-limitation regimes, including 'thin capitalisation' regimes based on debt-to-equity ratios, and limitations on deductions based on percentages of companies' earnings before interest, tax, depreciation and amortisation (EBITDA).

The paper nevertheless concludes that the suggested approach remains vulnerable to very difficult and perhaps intractable problems of identifying 'interest' in today's highly complex international environment. Therefore it will be very difficult at best for revenue agencies to administer successfully, even if the OECD's approach proves politically feasible. The paper recommends instead that countries devise means of incorporating the control of interest deductions into their generally applicable transfer pricing rules. Under this approach, excessive deductions of all kinds could simultaneously be limited to reasonable amounts. The paper suggests a format for a transfer pricing method that might fulfill this need, a Shared Net Margin Method (SNMM).

The paper concludes that if a more comprehensive approach to transfer pricing rules proves politically infeasible, the OECD's approach to interest deductions would represent a substantial improvement over current forms of interest limitations, and countries should adopt the OECD approach. For the longer term, however, effective control of interest deductions will probably require a thorough revision of transfer pricing rules, perhaps along the lines of SNMM.

Keywords: interest deductions; related-party loans; OECD; base erosion and profit shifting; BEPS; transfer pricing.

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Acronyms

BEPS	Base Erosion and Profit Shifting
EBITDA	Earnings before interest, tax, depreciation and amortisation
GAAP	Generally Accepted Accounting Principles
ICTD	International Centre for Tax and Development
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
SNMM	Shared Net Margin Method

Introduction

As part of its ongoing G20-mandated study of tax avoidance through base erosion and profit shifting (BEPS), the OECD has devoted substantial attention to the use of loans between members of multinational groups as a vehicle for shifting profits from countries in which group members conduct their business activities.¹ Loss of corporate tax revenue from intragroup loans poses a serious fiscal challenge to countries at all levels of economic development, but the losses appear to be especially pervasive for developing countries.² Further, the practical consequences of revenue loss are especially severe for developing countries, which, because of the typically large informal sectors of their domestic economies, tend to rely more heavily than other countries on corporate tax revenue from multinational companies.³

In a detailed discussion draft,⁴ the OECD has recently (i) reviewed countries' historical efforts to curtail revenue losses from related-party loans, and (ii) suggested, as a desirable model to be developed further, a proposal for a group-wide approach to the regulation of profit shifting through related-party loans, under which a group's total deductions for interest paid to unrelated parties are apportioned between group members based on measures of their relative levels of economic activity (OECD 2014). This paper offers observations on the potential strengths and weaknesses of the OECD's suggested approach, with particular attention to the question of the most constructive policies in light of the tax administration needs of developing countries. The discussion concludes that the OECD's suggested group-wide approach is markedly superior on several grounds to existing approaches to the control of interest deductions that are currently in effect in a number of countries around the world. Nevertheless, the vulnerabilities that will remain even in the improved approach may limit its effectiveness to such an extent that, despite its implementation, countries will remain unduly vulnerable to base erosion through excessive deductions for interest. This paper suggests further that these vulnerabilities are likely to persist under any strategy that attempts to limit BEPS through a combination of separate measures, which, like the suggested group-wide approach to interest deductions, are targeted narrowly at specifically defined categories of intragroup payments that are claimed to be deductible, such as interest on intragroup loans.

This paper argues that countries are more likely to achieve effective control of profit shifting through a more comprehensive approach that seeks to limit the aggregate amount of a taxpayer's deductions to levels that will leave the taxpayer with a reasonable level of taxable income, in view of both the overall profitability (or loss) of the taxpayer's group, and the level of the particular taxpayer's measurable economic activity. A comprehensive approach to base erosion of this kind, however, inevitably will be perceived as formulary apportionment by many participants in global tax policy discussions, thereby invoking fears of prohibitive technical barriers to implementation, as well as concerns resulting from the long and continuing history of political aversion to proposals to adopt formulary methods to apportion taxable income and deductions between different countries. In view of both the technical and

¹ At the inception of its *Action Plan on Base Erosion and Profit Shifting* in 2013, the OECD designated 'Limit base erosion via interest deductions and other financial payments' as Action 4 (OECD 2013: 17). Recent developments under Action 4 are described in detail below. For a current overview of the OECD's efforts on BEPS as a whole, see <<http://www.oecd.org/tax/beps-reports.htm>>.

² See generally the International Monetary Fund (IMF) report *Spillovers in International Corporate Taxation* (IMF 2014).

³ The IMF Spillovers Report devotes considerable attention to the special importance to developing countries of controlling base erosion through excessive interest deductions. The report notes that in some prominent instances important inbound investment in developing countries is almost entirely debt-financed, severely limiting the potential tax revenue from the projects (IMF 2014: 20, 30).

⁴ *OECD Public Discussion Draft, 'BEPS Action 4: Interest Deductions and Other Financial Payments'*, 18 December 2014-6 February 2015 [hereinafter Discussion Draft] (OECD 2014). The OECD held a public consultation on the Discussion Draft on 17 February 2015, and has released voluminous written comments that it received at <<http://www.oecd.org/tax/aggressive/public-consultation-action-4-interest-deductions-other-financial-payments.htm>>.

political challenges of any fully-fledged formulary system, it would indeed not be politically feasible at the current time for developing countries to attempt to implement one – despite the advantages it might offer over the less comprehensive approach to base erosion that is represented by the ongoing OECD BEPS effort.⁵ The discussion below, therefore, offers two recommendations – one for the short term, and the other for the medium term of, perhaps, three to five years:

- (i) Given the advantages over current global practice that are offered by the OECD's suggested group-wide approach to limiting interest deductions, developing countries should participate actively in attempts by the OECD and others to refine the group-wide approach and should join other countries in implementing the approach legislatively.
- (ii) In addition, ideally by coordinated analysis through regional tax organisations, developing countries should seek to develop a comprehensive response to base erosion that would operate more effectively than a combination of separately targeted measures. To some extent, an effective comprehensive approach will need to challenge the current widespread aversion to base-protection measures that can be described as formulary. It should, however, be possible to design measures that are reasonably comprehensive while at the same time not as novel or technically challenging as a full formulary system. The discussion below will address the reasons why it may be advantageous for developing countries, perhaps pooling their analytical resources through multilateral efforts, to develop a more comprehensive approach to base erosion than is likely to be achieved under the menu approach of OECD's BEPS project. A subsequent paper, based on a proposal outlined in a recently published article (Durst 2015a), will provide additional guidance on how countries might seek to construct a comprehensive method for controlling base erosion which, while having some elements of formulary apportionment, nevertheless might avoid some of the most difficult technical challenges of a formulary approach.

1 The Discussion Draft and the anatomy of profit shifting through related-party loans

1.1 The nature of the problem

Base erosion and profit shifting techniques come in many varieties; these include but are not limited to the use of loans between related parties.⁶ For example, perhaps the oldest form of base erosion structure, dating from at least the 1950s, typically centers on valuable items of intellectual property like pharmaceutical patents or software copyrights. In an intangibles-based profit shifting arrangement, the parent of a corporate group typically contributes cash to a subsidiary that is located in a zero- or low-tax country. The subsidiary then uses the cash to purchase, or perhaps to finance the development of, a valuable intangible that other group members operating around the world will use. The affiliates then pay royalties to the zero- or low-tax affiliate for use of the valuable intangible. These royalties typically are deductible by the group members paying them, thereby reducing these group members' tax liability, but there is no corresponding tax liability when the royalties are received by the zero-

⁵ With the assistance of ICTD, the author has written what is intended as a comprehensive analysis of a potential system of global formulary apportionment, with discussion of likely administrative strengths and weaknesses. The analysis is provided in eight articles published by Bloomberg BNA, Inc.; these are expected to be republished during 2015 as a combined volume. The articles in their current form are Durst (2014a, 2014b, 2014c, 2013a, 2013b, 2013c, 2013d, 2013e).

⁶ Base erosion and profit shifting have been the subject of voluminous literature, especially in recent years. Two important descriptions of base erosion transactions are available in Kleinbard (2011) and Joint Committee on Taxation (2010).

or low-tax subsidiary. The net result is that the group succeeds in avoiding taxation on large amounts of income earned by its affiliates in operations around the world.⁷

Profit shifting through the use of loans between members of commonly-controlled multinational groups is structurally similar to profit shifting through the use of valuable intangibles. In a loan-based profit shifting arrangement, the group's parent establishes and contributes cash to a zero- or low-tax subsidiary, which is to function within the group as an internal financing company. The financing company extends loans to other group affiliates typically located in higher-tax countries in which the affiliates conduct the group's business activities. Interest paid on the loans is deductible in the higher-tax countries, resulting in a reduction of tax in that country, but there is no corresponding tax liability on receipt of the interest by the zero- or low-tax financing company. Through payment of the interest, therefore, income of the operating affiliates effectively escapes taxation in the countries where those affiliates conduct the group's business. Because there are few if any market-based financial constraints on the level of debt of a wholly-owned subsidiary, internal loans can be much higher in aggregate than the actual borrowing by the group as a whole from third parties, and indeed the volume of tax avoidance through the use of related-party loans seems very large.

The revenue losses from loan-based profit shifting appear to affect countries at every level of economic development. The IMF has observed, however, based both on scholarly evidence and observation during its technical assistance activities, that profit shifting through intragroup loans seems to occur at a more serious scale for developing countries than for countries at other levels of economic development (IMF 2014: 18, 20). This may in part reflect the limited administrative resources of developing country revenue administrations, which restrict their ability to promulgate and enforce the limitations on interest deductions that are used widely in other parts of the world, however limited in effect they might be. In addition, the large volume of profit shifting through interest payments may reflect that the allowance of very high degrees of leverage represents a convenient, and politically relatively non-transparent, means of providing investors with effective exemption from corporate tax.⁸

The perception that loans between related parties can contribute to corporate tax avoidance is not of course new; on the contrary, the perceived problem extends to the earliest days of corporate income tax and predates today's preoccupation with tax avoidance in the international sphere.⁹ Early in the history of taxation, the problem typically presented itself in the context of the capital structure of corporations whose stock was owned entirely by an individual, or perhaps a group of individuals within a family. Under corporate tax rules interest paid by a corporation on its debt is treated as an expense and is deductible, but distributions by a corporation on its stock are not deductible by the corporation. This difference in treatment has always raised a tax-based incentive to weight a corporation's capitalisation away from stock (i.e. share capital) and toward greater reliance on debt. However, the corporation's ability to weight its capitalisation toward debt – that is, to over-leverage itself – is generally limited by the increasing riskiness of a company's debt as the company's ratio of

⁷ Many variants have been developed over the years of the basic base erosion transaction centred on the ownership of intangibles by zero- or low-tax group affiliates. For example, one popular structure uses zero- or low-tax affiliates as insurers of various risks, including inventory risks, borne by group operating affiliates around the world; profit shifting is accomplished through payment of insurance premiums, or numerous other kinds of economically equivalent payments, for the bearing of those risks.

⁸ IMF (2014: 20):

Many of the most spectacular [developing country revenue losses] relate to the extractive industries: a gold mining sector in which USD100 billion has been invested over the last decade, but which is almost entirely debt financed ... But the issues are not confined to the extractive industries: there are cases, for example, of telecom companies in Africa – often among the most profitable enterprises – being entirely debt financed.

⁹ For a thoughtful and comprehensive discussion of the difficulties posed by debt under corporate income tax, both domestically and internationally, see Benshalom (2010).

debt-to-equity capital increases. Therefore, the willingness of unrelated parties to extend loans to a company will eventually dry up as the company increases its leverage.

The same constraints do not apply, however, where a corporation is owned by one shareholder or a small group of shareholders. Shareholders in these circumstances do not face real financial risk when they lend money to their corporations, because by lending to their corporations they are in economic effect lending to themselves. Accordingly, the shareholders typically face a strong tax-based incentive to increase the amount of debt they extend to their corporations, and no countervailing economic constraint against doing so. The result has been a long tradition of shareholders of closely-held corporations seeking to leverage them to the hilt, and tax authorities countering by attempting to recharacterise some of the corporations' purported debt capitalisation as constituting equity in economic substance.

Traditionally, corporate tax laws have authorised tax authorities to recharacterise debt as equity using a facts-and-circumstances – also called an arm's-length – approach, essentially asking whether an unrelated lender would be willing to lend as much to the corporation as the shareholder or shareholders have purported to lend.¹⁰ This determination inevitably rests to a large extent on highly subjective judgments concerning the corporation's creditworthiness, typically involving scrutiny of the debt-to-equity ratio of the company as well as the apparent soundness of its business prospects. The result of this subjectivity has been a large volume of tax litigation over many decades, with few useful objective standards identified for distinguishing between debt and equity of the closely-held corporation.¹¹

The longstanding problem of distinguishing between companies' debt and equity took on a new dimension with the growing economic importance of the multinational business group. The finance company structure described above quickly became normal in international tax planning. Under this structure all the affiliates of the group around the world in effect constitute closely-held companies, and the finance company takes the place of the shareholder-creditor in the classic old-fashioned leveraging scenario. Moreover, just as attempts to control leverage based on subjective analyses of creditworthiness have proven ineffective in controlling leverage for domestic corporate tax purposes, these attempts have also proven ineffective in curtailing debt-driven base erosion in the international setting.

1.2 The OECD's proposed solution

In their attempts to control debt-based profit shifting, different countries over the years have enacted quantitative limitations on related-party indebtedness as supplements to the traditional facts-and-circumstances test. The recent Discussion Draft catalogues the measures that countries have taken, which typically have consisted of (i) limitations based on maximum debt-to-equity ratios that are specified by statute (that is, thin capitalisation limitations), (ii) limitations on interest deductions to a statutorily determined percentage of a company's income, and (iii) a combination of these two elements.¹²

Under a limitation based on debt-to-equity ratios, a taxpayer is permitted to deduct interest paid on related-party debt only to the extent the ratio of debt to equity in the taxpayer's capital structure does not exceed a specified ratio, for example three-to-one. Limitations of this kind have not, however, proven effective over the years, apparently because taxpayer groups can generally avoid them by injecting additional equity into a subsidiary, thereby

¹⁰ The arm's-length approach to distinguishing debt from equity is described in the Discussion Draft (OECD 2014: 13).

¹¹ See generally Benshalom (2010).

¹² These existing controls on interest deductions, which the OECD labels as fixed ratio approaches because they depend on statutorily specified ratios of either debt to equity or interest expense to income, are described in the Discussion Draft (OECD 2014: 12-15).

reducing its debt-to-equity ratio and permitting additional leverage.¹³ Also, because banks and other financial businesses tend, for business reasons not directly related to consideration of taxation, to be much more heavily leveraged than other kinds of businesses, limitations based on debt-to-equity ratios must typically incorporate complex exceptions to allow greater latitude to banks and other financial industry taxpayers.¹⁴

To remedy the vulnerability to taxpayer manipulation of limitations based on debt-to-equity ratios, countries in recent years have increasingly been adding to their statutes rules – either in combination with or as substitutes for rules based on debt-to-equity ratios – limiting a taxpayer's interest payments to specified percentages of the taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA). For example, statutes enacted by a number of countries in recent years limit interest deductions generally to 30 per cent of the taxpayer's EBITDA. The OECD report suggests, however, that the 30 per cent rule allows a significantly greater degree of leveraging than would typically occur between unrelated parties transacting with each other at arm's length (OECD 2014: 14). In addition, rules limiting interest deductions to fixed percentages of a taxpayer's income share the problem of limitations based on debt-to-equity ratios, of requiring exceptions for banks and other financial industry companies. Further, some taxpayers in addition to banks and other financial companies may for business reasons require debt capitalisation at levels above those consistent with any single limitation of interest deductions to a particular percentage of a taxpayer's net income. For these reasons the OECD concludes that limitations of interest deductions to specified percentages of a taxpayer's income, while superior to limitations based on debt-to-equity ratios, offer a less than ideal approach to the control of interest-based profit shifting.¹⁵

As a preferable method, the Discussion Draft suggests what it describes as a group-wide approach to interest limitations. Under a group-wide approach the total interest payments of group members, made to unrelated creditors, are divided for purposes of deduction between the members of the group, according to some measure of members' relative levels of business activity. The Discussion Draft explains that group-wide tests can be designed according to two formats, which are different in administrative design but of similar substantive effect:

- a group-wide interest allocation rule which operates by allocating a worldwide group's net third-party interest expense between group entities in accordance with a measure of economic activity (such as earnings or asset values); and
- a group ratio rule which compares a relevant financial ratio of an entity (such as net interest to earnings or net interest to asset values), with the equivalent financial ratio of the entity's worldwide group (OECD 2014: 29).

Conceptually, under both kinds of group-wide approach interest paid to unrelated creditors is treated as a business expense incurred for the benefit not of the particular group member or members that have formally contracted for the debt, but instead for the common benefit of all members of the group. The right to claim tax deductions for the interest cost is apportioned between the different group members according to an estimate of their relative benefits from the indebtedness, with these relative benefits measured by the members' incomes.

¹³ The Discussion Draft observes that limitations of interest deductions based on debt-to-equity ratios 'can be easily subject to manipulation, for example by a controlled entity issuing new share capital to its parent which does not correspond with any increase in economic activity' (OECD 2014: 12)

¹⁴ See the discussion of special problems of regulating the interest deductions of banks, insurance companies and other financial industry businesses in the Discussion Draft (OECD 2014: 62). As discussed further below, the proper treatment of banks, insurance companies and other financial businesses will pose challenges under any approach to the regulation of interest deductions, including the improved approach suggested by the OECD as well as more comprehensive approaches to BEPS.

¹⁵ The Discussion Draft summarises the inherent shortcomings of both kinds of fixed ratio approach (OECD 2014: 47-52).

The group ratio approach offers the important benefit, over limitations based on either pre-fixed debt-to-equity ratios or income-based limitations on deductions, of self-adjusting to the different debt-to-equity ratios of different kinds of businesses. It also rests on a more satisfying conceptual model than either of those approaches – the view of the aggregate outside interest expense of the group providing a benefit to all group members, in proportion to their levels of economic activity.

The rationale for the group-wide approach to limiting interest deductions is similar to that of a system of formulary apportionment designed to apportion not only interest deductions, but all items of income and expense for tax purposes, between the members of commonly-controlled groups. The OECD's willingness to entertain a group-wide approach, even for the limited purpose of apportioning interest deductions, therefore might be seen as an indication that, despite its longstanding historical aversion to a fully-fledged system of formulary apportionment, it is willing to consider a move towards methodologies involving apportionment to address the particular problem of profit shifting using loans. The OECD's embrace of the group-wide test, with its formulary elements, is especially striking in light of the fact that the Discussion Draft explicitly rules out reliance on a facts-and-circumstances, arm's-length approach to the regulation of interest expenses as impracticably demanding on tax administrations.¹⁶ A number of public comments criticise the OECD's recommendation against reliance on the arm's-length approach in this context.

1.3 Remaining difficulties

Nevertheless, notwithstanding the improvements the group ratio test offers over existing approaches to the control of interest deductions, the OECD's suggested group-wide approach remains vulnerable to important difficulties which could seriously limit the success of the proposed approach. These difficulties, which the OECD airs extensively in its Discussion Draft, arise primarily from two related problems inherent in the definition of interest.

The most pervasive difficulty facing even greatly improved limitations on interest deductions is the problem of defining debt and interest. Especially in today's highly complex financial markets, many kinds of arrangements that are not labelled as debt serve functions similar or identical to those of debt, and many kinds of payments related to those arrangements, which are not labelled as interest, nevertheless serve functions economically equivalent to those of interest.

The variety of financial arrangements that can be economically equivalent to debt, and can involve payments that are economically equivalent to interest, is well known. Among the most common are: (i) repurchase arrangements (repos) on stock or other property; (ii) sale-leaseback arrangements; and (iii) the virtually infinite variety of financial derivative

¹⁶ The Discussion Draft rules out reliance solely on an arm's-length approach to limiting interest deductions, explaining: An arm's length test requires consideration of an individual entity's circumstances, the amount of debt that the entity would be able to raise from third-party lenders and the terms under which that debt could be borrowed. It allows a tax administration to focus on the particular commercial circumstances of an entity or a group but it can be resource intensive and time consuming for both taxpayers and tax administrations to apply. Also, because each entity is considered separately, the outcomes of applying a rule can be uncertain, although this may be reduced through advance agreements with the tax administration. An advantage of an arm's length test is that it recognises that entities may have different levels of interest expense depending on their circumstances, and should not disturb genuine commercial behaviour. However, some countries with experience of applying such an approach in practice expressed concerns over how effective it is in preventing base erosion and profit shifting, although it could be a useful complement to other rules. The concerns are that existing arm's length tests may not be fully effective against base erosion and profit shifting because they only apply to intra-group payments and they permit deductible interest to be supported by non-taxable assets or income, such as investments in subsidiaries. While it might be possible to introduce new arm's length tests without these limitations (for example, by applying an arm's length rule to all of an entity's debt and by disregarding non-taxable assets and income when assessing whether an arm's length test is met), such rules would be burdensome to apply and enforce, and may still prove ineffective. (OECD 2014: 13)

transactions, including swaps of many kinds.¹⁷ All of these can entail payments from one party to the other that, like interest, constitute compensation for the time value of money. In deference to the variety of financial arrangements that can serve the economic function of debt, existing limitations on interest deductions typically apply not only to payments that are explicitly labelled as interest, but also to amounts that are equivalent to interest. The OECD's suggested group ratio approach would incorporate a similar rule.

But simply extending the terminology of an interest limitation to cover amounts equivalent to interest does not constitute a solution to the underlying problem. Given the infinite variety of financial transactions that can be devised, the question of whether or not particular payments are equivalent to interest is not a matter of classifying payments on either side of a bright-line rule. Instead, the many different kinds of financial arrangements that are found in today's complex economy fall along a continuum on which some kinds of arrangements more or less clearly involve compensation for the time value of money, which should be classified as equivalent to interest. It is often impossible to determine convincingly whether a payment should or should not be treated as equivalent to interest, and the infinite possibilities of contemporary financial practice offer unlimited opportunities to cloud this often-difficult question if that is desired.

The difficulty of distinguishing between (i) interest and amounts equivalent to interest, and (ii) other kinds of financial payments, is almost certain to pose especially serious problems for tax administrations in the poorer developing countries. Even the most well-financed revenue agencies have difficulty retaining the sophisticated staff of financial experts needed even to attempt the necessary analysis. The hiring of these personnel is well beyond the budget of most developing country revenue agencies.

The introduction by governments of potentially effective limits on interest deductions would create an even greater incentive than exists today for companies to engage in tax planning techniques involving debt-like financing that is disguised as other kinds of transactions. Although it is impossible to predict the full extent of the difficulties that might arise, the kind of financial engineering that would be involved is already well-known to tax practitioners around the world. It seems likely that planning techniques involving disguised debt would significantly impair the effectiveness of any limitation on interest deductions, including the improved approach suggested by the OECD.¹⁸

In addition, the design of an effective group-wide limitation of interest deductions will require addressing a number of questions of technical design, which the Discussion Draft identifies but generally leaves to public consultation and further work to resolve (OECD 2014). Unlike the problem of identifying amounts that are equivalent to interest, these design questions do

¹⁷ The Discussion Draft provides a long and non-exclusive list of payments that can be seen as equivalent to interest: A best practice rule to address base erosion and profit shifting using interest expense should therefore apply to: (i) interest on all forms of debt; (ii) payments economically equivalent to interest; and (iii) expenses incurred in connection with the raising of finance. These payments should include, but not be restricted to:

- payments under profit participating loans;
- imputed interest on instruments such as convertible bonds and zero coupon bonds;
- amounts under alternative financing arrangements, such as Islamic finance;
- the finance cost element of finance lease payments;
- amounts re-characterised as interest under transfer pricing rules, where applicable;
- amounts equivalent to interest paid under derivative instruments or hedging arrangements related to an entity's borrowings;
- foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;
- guarantee fees with respect to financing arrangements; and
- arrangement fees and similar costs related to the borrowing of funds.

(OECD 2014: 17-18)

¹⁸ It seems possible that the continued reliance by governments on highly porous fixed ratio approaches to the limitation of interest deduction reflects the fact that more effective limitations like, potentially, the OECD's suggested group-wide approach would require tax administrations for the first time to address seriously the challenges of the 'equivalent to interest' problem.

not appear to involve fundamental obstacles to the effective operation of the rule. Nevertheless, they do involve potentially serious complications of the administration of any interest limitation rule, including the OECD's suggested group-wide approach. These issues include the following:

- (i) *The special difficulties posed by banks, insurance companies and other financial businesses.*¹⁹ Banks, insurance companies and other kinds of financial businesses earn their income, in large part, by the purchase of debt instruments of various kinds and the investment of the proceeds in other interest-bearing investments. The ratio of interest expense to income of these businesses therefore tends to be very high, and even relatively small uncertainties in identifying amounts that are equivalent to interest can seriously distort the application of an interest limitation rule to banks, insurance companies and other financial businesses. In addition, as discussed below, it is likely that an interest limitation rule following the group-wide approach will apply to taxpayers' net rather than gross interest expenses. Profitable financial institutions, however, are always in a net positive position with respect to interest, since they earn income based on the spread between interest paid and interest received. Further, the smooth operation of a group-wide interest limitation assumes that taxpayers generally will be free to re-apportion intragroup debt between group affiliates so that their actual debt outstanding conforms to the interest ceilings established by the group-wide limitation – but non-tax regulations often limit the extent to which legal entities within banking and insurance groups can adjust their levels of outstanding debt. For all these reasons, it seems inevitable that a group-wide interest limitation regime would need to exempt banks and insurance companies, and probably other kinds of financial businesses, or apply different rules to them. This requirement would to some extent reduce the effectiveness of the limitation in preventing profit shifting; it may also prove difficult to define the kinds of financial businesses, other than regulated banks and insurance companies, to which the necessary carve-out will apply.
- (ii) *Identifying the boundaries of the group to which a group-wide limitation should apply* (OECD 2014: 33-34). For want of any useful alternative, it seems inevitable that a group should be defined, for purposes of the envisioned group-wide interest limitation, by reference to the rules governing consolidation under the particular accounting system under which the particular group operates (for example, Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS)). This will leave open opportunities for tax avoidance through the use of entities that are financially related to group members but that, for one reason or another, fall outside the boundaries of accounting consolidation. It seems inevitable to this author that statutes will need to incorporate anti-abuse rules enabling tax administrations to address apparent tax avoidance involving entities that have economic ties to a group but are not formally included within the group.²⁰
- (iii) *Whether interest should be apportioned by reference to income or asset values* (OECD 2014: 39-41). Although in theory asset values can provide a good measure of the relative ability of different group members to carry burdens of debt, in practice, as the Discussion Draft observes, it can be much more difficult to appraise asset values than to measure income flows. Asset valuations are made even more difficult by the fact that much of companies' value today consists of intangible assets. Although the Discussion Draft leaves the question open, it seems very likely that any group-wide approach to limiting interest deductions will operate by reference to companies' income levels, rather than valuations of their assets.

¹⁹ See especially the Discussion Draft (OECD 2014: 62-63). Many of the public comments submitted to the OECD on its Discussion Draft were provided by banks, insurance companies and other financial taxpayers.

²⁰ See the discussion of connected and related parties in the Discussion Draft (OECD 2014: 44-45).

- (iv) *Whether a limitation should apply to an entity's gross or net interest expense* (OECD 2014: 23). There would appear to be no theoretical reason why the fact that a taxpayer earns their income in the form of interest, rather than in some other form, should reduce the extent to which a taxpayer is subject to limitations on the deductibility of interest costs. Therefore, as a theoretical matter it would appear that an interest limitation should apply to a taxpayer's gross rather than net interest income. As a practical matter, however, the only way that taxpayers are likely to adjust interest payments between group members, in order to afford the group as a whole the full measure of its allowable interest deductions under a group-wide approach, is to adjust intragroup debt from time to time between different pairs of group members. Basing a disallowance of debt on a taxpayer's gross rather than net interest expense would have the effect of defeating this adjustment mechanism, which probably would cause the rule to be seen as operating unduly harshly with respect to many groups. Therefore, it seems very likely that interest limitations will in practice apply to taxpayers' net interest payments, notwithstanding that this approach might increase opportunities for tax avoidance, particularly for taxpayers in industries which typically derive significant portions of their income in the form of interest receipts.
- (v) *Whether rules should allow a carry-forward of disallowed deductions* (OECD 2014: 59-61). The Discussion Draft notes that existing limitations on interest deductions typically allow taxpayers to carry disallowed deductions forward into future years, either with no time limitation on use of the carried-forward deductions, or for specified numbers of years (ranging from three to eighteen in the national statutes that are summarised in the Discussion Draft). Carry-overs respond in large part to the fact that often interest deductions are incurred with respect to an income-producing investment one or more years before the investment is expected to generate net income. In addition, institutional or regulatory constraints may prevent a group from rearranging its internal debt during a year so that the group's external interest expenses can be spread throughout the group so as to minimise the amount of interest that is disallowed within each entity. Therefore, some entities in a group may find themselves with deductions disallowed within a year, even though as a whole the group's deductions do not exceed the total deducted on the group's external debt. As a practical matter, under any group-wide limitation on interest deductions carry-overs are very likely to be allowed in order to mitigate the perceived excess taxation that otherwise might result in either of these situations. The Discussion Draft does not seek to prescribe an applicable time period, but uses five years as an example of one that might be allowed.
- (vi) *De minimis rules and combination tests* (OECD 2014: 25-26, 52-54). The group-wide approach suggested by the OECD, while desirable on a number of grounds, would involve a substantial administrative burden for both taxpayers and tax administrations, and it would be sensible to require application of a group-wide test only where the possibility exists for substantial tax avoidance through excessive deductions of interest. Therefore, taxpayers with only small amounts of interest deductions might be exempted from application of the interest limitation rules entirely. In addition, a combination approach might be employed, under which taxpayers that meet very low fixed ratio tests – for example, that have deductions only of, say, 10 per cent of their EBITDA – might be exempted from computing and applying the group-wide test. Possibly *de minimis* rules and a combination approach might be used together, so that only large taxpayers showing significant potential for excessive levels of interest deduction would need to test their results using a full-blown group-wide computation. The construction of *de minimis* rules and combination approaches will require each country to accomplish a trade-off between the interests of administrative simplicity and the possibility of leakage of revenue through unduly generous exemptions from applying the group-wide test.

In sum, the OECD's suggested group-wide approach should be capable of controlling profit shifting more effectively than the various limitations on interest deductions that are now in effect around the world. Unlike limitations that are based on fixed debt-to-equity ratios, the group-wide approach cannot be circumvented by the relatively simple expedient of adding equity financing to a company's balance sheet. In addition, the group-wide approach adjusts much better to taxpayers' differing business needs for debt financing than limitations based on either a fixed debt-to-equity ratio or a fixed percentage of a taxpayer's income. Therefore, for most taxpayers it should not be necessary to structure group-wide limitations as permissively as today's fixed-percentage-of-income limitations appear generally to be structured.

Nevertheless, despite its improvements over existing limitations on interest deductions, the group-wide approach appears to remain vulnerable to a number of potential difficulties in operation. Some of these potential difficulties arise from the complexity, and opportunities for leakage of tax revenue, that are likely to be associated with the various special rules that will be necessary in implementing the statute, including the limitation of net rather than gross interest expenses, the allowance of carry-overs, and the carving out of special rules for banks, insurance companies and other financial businesses. Although these rules are familiar under existing interest limitation statutes, the porosity of existing limitations generally has prevented the effectiveness of the technical elements of the limitations from being tested under much enforcement stress.

In addition, and more importantly, the group-wide approach will remain vulnerable to the fundamental problem of any regulatory measure that is targeted specifically at deductions for payment of interest and amounts economically equivalent to interest. The distinction between amounts that are and are not equivalent to interest is often complex and subjective; tax practitioners are very adept at exploiting the many unavoidable ambiguities in the definitions of particular kinds of financial instruments. Moreover, the general ineffectiveness of existing limitations on interest deductions means that the extent of the vulnerability of interest limitations to fundamental ambiguities of definition has not yet been tested. There appears to be a serious likelihood that new limitations based on the group-wide approach would quickly become subject to substantial avoidance through the legal structuring of novel kinds of financial instruments.

This does not necessarily mean that countries, including developing countries, should not adopt the Discussion Draft's approach. The group-wide approach does appear to eliminate or reduce the severity of some of the vulnerabilities that have affected existing limitations on interest deductions; the OECD's plans for further technical refinement of the approach appear promising. Therefore, if the only option that is realistically available to countries at this time in order to seek to control profit shifting is a menu of separate measures that are directed at specifically defined categories of base-erosion transactions, then a group-wide limitation on interest deductions would fit sensibly into that menu.

Difficulties resulting from exploitation of the ambiguities of legal definitions are not confined to limitations on interest deductions, however, but would apply also to other likely components of an approach to BEPS based on a menu of rules targeted at different, separately defined categories of base-eroding payments. It would seem desirable to consider whether it might instead be feasible, both technically and politically, to include the control of profit shifting through interest deductions within a more inclusive and unified system of control over the various kinds of deductible payments by which BEPS might be effected.²¹

²¹ In this connection, the comments submitted to the OECD on the Discussion Draft (see footnote 4) by the BEPS Monitoring Group, a consortium of non-governmental organisations, while welcoming the improvements represented by the OECD's group-wide approach, nevertheless notes, '[W]e would generally favour a move to the more comprehensive

2 Is a broader approach to base erosion feasible?

Base erosion and profit shifting depend upon the use of deductible payments of varying kinds in order to separate taxable income from the taxable entity that, through its activity, generated the income. An overarching goal of the OECD's BEPS initiative is to bring about greater congruence between the locations in which business activity takes place and the jurisdictions to which taxable income is apportioned.²² In view of the difficulty of defining each of the many different kinds of payments between related companies that can be used to effectuate base erosion, and particularly of the inevitability of gaps between the various definitions, it would seem more promising to address base erosion not through a menu of separate limitations on different kinds of base erosion payments that have been specifically defined, but instead on the basis of a requirement that after all deductions of all kinds have been taken, taxpayers are left with a level of taxable income that is sensible in light of the business activities that the taxpayer has conducted.

The difficulties described above in defining interest and debt are not the only well-known examples of the difficulty of trying to categorise base erosion transactions by means of terminological definitions. Another example is provided by the transmogrification, over the last twenty years, of relatively simple base erosion transactions based on royalties into a large variety of 'supply chain' and 'risk-bearing' transactions involving taxpayers in virtually all industries, some of which do not involve the ownership of any identifiable intangible assets. An attempt to control base erosion through a series of separate limitations on specified kinds of deductions will inevitably leave room for the design of variants of existing transaction patterns that do not conform, or in any event do not conform unambiguously, to any of the definitions set forth in the menu of separate control measures.

Attempting to control base erosion with a menu of separate limitations, rather than a unified requirement that reasonable amounts of income be left in countries after deductions of all kinds have been taken, also invokes a particular kind of political difficulty to which tax policymaking has always been vulnerable. Attempts to address tax avoidance through a number of separate measures, rather than through one or a few more unified measures, inevitably adds complexity to the policymaking process and thereby reduces both the effective transparency of the political process and the likelihood that effective changes will ultimately be enacted. In particular, the multiplication of different proposed measures to control a phenomenon like base erosion creates many different opportunities for lobbying by different interested constituencies, perhaps resulting in a complex legislative compromise that seems fair at face value, particularly to those without professional expertise in taxation, but in practice will leave open many gaps for continued tax avoidance. A more unified approach to base erosion, which seeks to identify a reasonable level of income for a taxpayer operating in a particular country after deductions of all kinds have been taken, would seem less vulnerable to degradation through complex political negotiations over technical provisions which may be difficult for legislators to understand.

Nevertheless, despite the potential advantages of a unified approach to base erosion transactions, from the start of its BEPS initiative the OECD has had no realistic alternative to building its proposals around a menu of measures targeted specifically at different kinds of

apportionment solution, which is extending the profit split method, which fairly and easily apportions both costs and revenues' (OECD 2015: 113).

²² The OECD *Action Plan*, which inaugurated the BEPS process, states as a central goal '[a] realignment of taxation and relevant substance' (OECD 2013: 13). A report of the G-20 group of countries describes this goal as that of putting 'an end to the divorce between the location of profits and the location of real activities' (G20 2013: 2).

deductible payments. The alternative, of seeking a comprehensive method to require of taxpayers reasonable levels of income in relation to their observable levels of business activity, after all base-eroding payments have been made, inevitably would be labelled as a kind of formulary apportionment similar to the method used by the US states and Canadian provinces for dividing taxable income between jurisdictions. Formulary apportionment of taxable income in the international sphere has long been opposed vigorously by taxpayer and practitioner groups, and in recent years has been rejected by the main global tax institutions, including especially the OECD.²³

Opponents of formulary approaches to controlling base erosion raise a number of arguments, including that formulary measures would generate imprecise measures of taxpayers' economically proper levels of taxable income, leading to economic distortions; would lead to excessive levels of double taxation as different countries inevitably adopt different formulas; and would impose on both taxpayers and tax authorities intractable accounting requirements. This author and others have questioned whether these arguments in fact raise persuasive arguments against formulary approaches to the control of base erosion, especially compared to the complexities and porousness of existing controls. Nevertheless, it is fair to say that formulary apportionment continues to have little support among those engaged in tax policy discussions around the world today, from either the private or governmental sectors.

It seems likely to this author that whatever the merits of the substantive arguments for and against formulary apportionment, opposition to formulary approaches arises at least in part from a shared aversion among taxpayers and many tax policymakers to the potentially greater effectiveness in curbing tax avoidance that a unified rather than menu approach to base erosion might afford. This shared aversion appears to arise from a convergence between taxpayers' always-present reluctance to see their effective tax burdens increased, and the fear of many tax policymakers that adopting effective systems for preventing international profit shifting would place their economies at a competitive disadvantage in the international marketplace for investment. This picture of the converging political perspectives of taxpayers and tax policymakers suggests that a menu of specifically targeted measures against base erosion, despite its inherent limitations, may represent the only politically realistic response to base erosion for the foreseeable future.

Nevertheless, the likely shortcomings of even a well-designed menu approach to profit shifting raises the question of whether developing countries might be able to push the envelope of what is politically feasible, and adopt a comprehensive approach to the control of base erosion that seeks to require companies to achieve sensible bottom-line levels of income, rather than to restrict specifically identified kinds of deductions. The method need not be as ambitious, administratively or politically, as a fully-fledged system of formulary apportionment: instead the method might be designed to fit within the category of a 'formulary profit split' or 'hybrid' approach to transfer pricing, which the IMF has suggested for further consideration in its paper on spillovers in international taxation (IMF 2014: 41-42).²⁴ Under a hybrid approach to transfer pricing, existing transfer pricing methods might be modified to achieve the effect of ensuring reasonable bottom-line levels of taxable income within the different members of a taxable group, without invoking all the potential complexities of formulary apportionment.

In a recent article, the author has proposed for further study one possible kind of formulary profit split that if successfully implemented might curtail base erosion from many sources, including interest deductions, yet be simpler administratively than full systems of formulary

²³ The author has sought to provide a comprehensive overview of the possibility of formulary apportionment for international use, including arguments both for and against formulary approaches, in a series of eight articles which were prepared with support from ICTD (Durst 2014a, 2014b, 2014c, 2013a, 2013b, 2013c, 2013d, 2013e).

²⁴ See generally Durst (2015b).

apportionment like those used by the US states and Canadian provinces (Durst 2015a). The basic approach of the suggested method, which the article calls the Shared Net Margin Method (SNMM), is to require the member of a multinational group that is operating in a particular country to earn a profit margin that is based on the global profitability of the multinational group as a whole. In particular, the method would employ a two-factor formula under which each group member would be required to earn a profit margin based on the member's level of sales and expenses during the year, that is equal to the margins earned by the group as a whole on the group's aggregate sales and expenses.

A key element of the proposed method is that, unlike existing transfer pricing methods which seek to divide between the different group members only a group's *operating* income and deductions (a measure that does *not* include most interest deductions), the proposed new method would divide a group's income after *all* deductions have been taken, including interest deductions. The proposed new method, therefore, would depart from the traditional practice of treating interest deductions as fundamentally different from other corporate deductions – a practice that historically has shielded interest deductions from effective control by transfer pricing enforcement. Under the suggested new method, interest deductions, like all other deductions, would in effect be apportioned between group members according to the members' relative levels of economic activity. Therefore, the suggested new transfer pricing method would essentially incorporate a group-wide apportionment of interest deductions similar in effect to the group-wide approach suggested in the recent OECD Discussion Draft.

The details of the suggested new transfer pricing method are beyond the scope of the current paper: they are provided in a rather technical format in a Bloomberg BNA article (Durst 2015a), and they will be explored from the standpoint of developing country tax policy in a forthcoming paper that is intended to accompany the current one. The basic functioning of the suggested method, however, can be seen by a brief example.²⁵

Consider Globalgroup, a global consumer product group headquartered in country X, which during 2014 earned consolidated pre-tax earnings of \$4 billion on revenue of \$68 billion, and incurred total costs of \$50 billion. Therefore, Globalgroup's consolidated ratio of earnings before tax to consolidated revenue is \$4 billion divided by \$68 billion, or 5.9 per cent; and Globalgroup's consolidated ratio of earnings before tax to total costs is \$4 billion divided by \$50 billion, or 8.0 per cent. A subsidiary of the group, Subco, conducts both manufacturing and distribution activities in country Y, and during 2014 earned revenue, per its financial statements, of \$9 billion and incurred total costs of \$7 billion. Under SNMM, Subco must for tax purposes report earnings before tax of

$$\frac{1}{2} \times (.059 \times \$9 \text{ billion} + .080 \times \$7 \text{ billion}), \text{ or } \$545.5 \text{ million.}$$

The suggested method is quite similar in structure to a method that is commonly used today in transfer pricing practice, the Transactional Net Margin Method in the OECD *Transfer Pricing Guidelines*. Therefore, adapting to the new method should place fewer demands on tax administrators and corporate tax personnel than would fully-fledged formulary apportionment, which would involve a volume of computations that is unprecedented even in the complex environment of international taxation. Moreover, the notion of using the combined profitability of more than one group member as a benchmark for a particular member's expected profitability is not unknown in current transfer pricing practice, as it is the basis of all profit split methods.

Nevertheless, the suggested new method would depart from all current transfer pricing methods in a fundamental and important respect. The OECD *Transfer Pricing Guidelines*,

²⁵ This example is adapted from Durst (2015a).

which are based on a historically firm aversion to formulary apportionment,²⁶ insist that each of the different categories of transactions in which a taxpayer engages must be tested separately, under transfer pricing methods that are selected as appropriate to those particular transactions.²⁷ The *Transfer Pricing Guidelines* do not countenance methods that would seek to divide income from more than one line of business of a taxpayer. Hence, the *Transfer Pricing Guidelines* as presently worded run counter to the notion of a single method that would seek to divide all of a taxpayer's income and deduction from all sources – including interest deductions, which often cannot be attributed to any particular activity or set of activities engaged in by a taxpayer. In the author's view, the broad, across-the-board division of all of a group's income and deductions under SNMM would represent a marked improvement over current transfer pricing practice, which often requires highly complex accounting assumptions to be made in fragmenting a taxpayer's operations between separate activities. Nevertheless, the across-the-board nature of income apportionment under SNMM could also be seen as sacrificing precision in the division of income between group members, with various adverse implications. This topic, which is likely to be central to any debate over possible implementation of a transfer pricing method resembling SNMM, will be addressed in the forthcoming paper mentioned above.

In addition to any administrative difficulties the envisioned departure from a transactional focus might properly be seen to raise, the departure, by moving transfer pricing rules unmistakably in a formulary direction, is certain to elicit political opposition should governments seriously entertain the adoption of SNMM or a similar transfer pricing method. Nevertheless, as the BEPS project moves towards its conclusion it would seem potentially useful to evaluate the package of proposals that are emerging and to compare the emerging approach with a possible alternative, notwithstanding that alternative's departure from existing practices governing the international division of taxable income and deductions. This comparison may be of particular importance to developing countries, which have greater reasons than other countries to protect their tax bases against cross-border erosion.

3 Conclusion

The OECD's current efforts to curtail base erosion through interest payments are of substantial potential importance to developing countries. The particular approach recommended by the OECD to limit deductions of interest – a group-wide approach, under which an entire corporate group's deductions for interest paid to unrelated lenders would be divided between all group members according to a formula – should provide better protection against revenue loss than countries' existing limitations on interest deductions, which are based either on taxpayers' debt-to-equity ratios or on the ratio of their interest deductions to their net earnings.

Even the OECD's improved approach, however, is vulnerable to excessive complexity and revenue loss, largely because of unavoidable ambiguities in defining the interest payments to which the group-ratio test would apply. Given the very large resources that multinational groups routinely devote to tax planning, it seems likely that taxpayers will quickly gain effectiveness in exploiting the ambiguities that the OECD's approach leaves unaddressed, perhaps greatly reducing the effectiveness of the proposed approach.

²⁶ Paragraphs 1.16 through 1.32 of the OECD *Transfer Pricing Guidelines* consist of a strong rejection of the idea of international formulary apportionment (OECD 2010).

²⁷ The OECD *Transfer Pricing Guidelines* therefore prescribe, for example, the transactional net margin method (OECD 2010: 2.58-2.107) and the transactional profit split method (OECD 2010: 2.108-2.145).

Developing countries might achieve better protection against base erosion by seeking to control excessive interest deductions as part of a more broadly aimed effort to control base erosion from many sources, using a comprehensive transfer pricing method which would resemble a system of international formulary apportionment but avoid some of its technical difficulties. This paper has briefly described one possible kind of hybrid method, a Shared Net Margin Method (SNMM). Other possible versions of a comprehensive transfer pricing method, which simultaneously would control deductions for interest as well as other kinds of base-eroding payments, might also be envisioned. A transfer pricing method of this kind would obviate the need for special limitations on interest deductions, including those described in the OECD Discussion Draft.

The successful development of a transfer pricing method of this kind, however, will require substantial additional analytical work and will inevitably encounter significant political resistance. A follow-up paper to this one will offer some additional analysis, which it is hoped will prove useful to policymakers who may wish seriously to consider SNMM or a similar transfer pricing method. Nevertheless, at this time SNMM should be seen as a suggestion for further development, ideally by policymakers in national governments and intergovernmental bodies, and neither it nor a similar transfer pricing method is likely to be implemented by any country or group of countries in the near term.

As a short-term strategy, therefore, the OECD's suggested group-wide interest limitation offers meaningful improvements over existing kinds of limitations, and developing countries should participate in further efforts to develop the OECD approach and strongly consider adopting any resulting statutory language. Countries should be prepared, however, for implementation of the new approach to encounter significant difficulties in enforcement, especially as tax planners structure transactions to avoid whatever definitions of interest and debt are contained in the implementing legislation. For longer-term protection from base erosion developing countries, ideally through regionally coordinated efforts, should begin the work of building and evaluating comprehensive transfer pricing methods which could protect against base erosion more effectively than the currently envisioned menu-based approaches.

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